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Development of Term Lending

BECAUSE THE FORCES THAT brought about the emergence of term lending about 1933 are almost inextricably connected with the factors that nourished its growth during ensuing years, it would be illogical to separate the problems of origin and development. An accurate view of the major processes at work in the business credit market since 1933 may be achieved by grouping the numerous events bearing on term lending into the following categories:

1. Factors causing a relative growth in the demand by American business enterprises for medium-term credit, and especially for term loans as opposed to short- or long-dated loans or equity capital.
2. Factors relatively reducing the incomes that lending or investing agencies could obtain, for any degree of risk assumption, by extending credits of other types than term loans.
3. Changes in public regulation and supervision of lending agencies of a nature that permitted them to enter the field of medium-term business credit with more assurance.

Obviously the first group of factors concerns the demand side of the market while the second and third relate to the supply of business credit.

Relative Growth in Demand for Medium-Term Business Credit Since 1933

The evidence points to the conclusion that at least since 1933 there has been a relative shift of demand by business enterprises from equity financing to debt financing, as a result of the relatively unfavorable terms on which common stocks and, to a lesser degree, preferred stocks could be sold. The preference for creditorship that developed in the United States following 1929 has served to increase the percentage spread between yields of common stocks and yields of high-grade bonds far beyond previous American experience or that of the industrialized nations of Europe.[1] Unquestionably this is one of the influences behind recent changes in the ways in which business is financed. Entrepreneurs themselves undoubtedly preferred to avoid debt and were willing to offer sizable premiums to purchasers of equity securities, but the comparatively large disadvantages of procuring funds by selling equities as against contracting loans worked to overcome this preference.

Apart from this basic tendency to shift from equity to debt financing, strong economic and institutional forces have been in operation to increase, both in form and in fact, entrepreneurial preferences for medium-term debt. The protracted industrial revival which (with occasional interruptions) developed after 1932 found many concerns with deteriorated plant and equipment and in a straitened working capital position as a result of the operating losses experienced during the downswing. These concerns required additional funds, and a majority found it advantageous to borrow them. At the same time, businessmen were vividly aware of the pressure that had been put upon them by commercial banks during the contraction period of 1929-32 to liquidate their short-term obligations. As a rule these credits originally had been extended with a realization by both banker and business executive that the funds would be used to finance industrial operations of a type that would not conveniently permit of complete liquidation at their legal dates of maturity. The runs on banks during the banking crisis compelled bank managements to convert assets into cash at as rapid a rate as possi-

[1] See, for example, the treatment of this phenomenon in G. Colm and F. Lehmann, *Economic Consequences of Recent American Tax Policy* (Supplement I of *Social Research,* 1938) and by Albert G. Hart in his remarks before the annual conference of the American Statistical Association, Chicago, December 1940. A. Wilfred May has given a provocative analysis of the salient facts in his article entitled "American and European Valuations of Equity Capital," in *American Economic Review* (December 1939).

ble, even at the cost of severe embarrassment or insolvency of their business debtors.

It is therefore understandable that the business community faced the 1933-37 period of upswing with a desire to avoid the short-term commitments that had only recently wrought such difficulties for them. There was an expanded demand for credit, but not for the traditional form of short-term banking credit.[2] In short, the great depression following 1929 heightened the weaknesses latent in the old business credit forms. Term loans developed partly in recognition of the need for rewriting credit terms to conform more closely to the economic nature of the underlying business transactions, thus protecting the economy from the shock of sudden enforcement of unsuitable credit terms.

The rejuvenated demand for money to modernize, reorganize or renovate plant and equipment and to finance expanding productive activities, taken together with the aversion of business management for short-dated bank loans, would normally have caused an increase in the demand for credit from investment bankers. In the absence of other forces, this would have led to an increase in the quantity of publicly offered corporate bonds and debentures. But to a significant degree the expanding credit demand was prevented from expressing itself in that form. One cause was regulation of the securities markets imposed by the Securities Act of 1933. This law placed considerable burdens upon issuers, underwriters, and experts particpiating in the preparation of registration

[2] One manifestation of this attitude is the effort exerted by business management to minimize the amount of short-term debt revealed on balance sheets. In accordance with accepted accounting practices only debts due in less than one year need be carried in the "current liabilities" section of the balance sheet, other indebtedness being grouped with "capital" items. Trade suppliers as well as financial institutions usually give great weight to the "current" position of a business in judging its credit. Consequently, one ancillary cause of the increase in demand for term loans, as opposed to traditional short-term banking credits, has been the fact that the term borrower need show those instalments of the loan that are due within one year as a "current" liability. This factor has also exerted some influence on methods of accounts receivable financing during recent years. See forthcoming publication of the National Bureau of Economic Research (Financial Research Program), *Accounts Receivable Financing*, by Raymond J. Saulnier and Neil H. Jacoby.

statements and prospectuses. The expenses of securing elaborate data and of preparing and filing registration statements were large. Combined, they greatly increased the costs of obtaining credit from the public through investment bankers, especially for those issues of less than $10 million which account for the largest amount of term loans made by commercial banks.[3] From the point of view of social welfare these costs may have been wisely imposed. Despite them, there was a considerable expansion in the amount of corporate debt securities underwritten after 1933. Nonetheless, the Act channelized some part of the demand for business credit away from public issues, and directed it toward loans that could be negotiated without the comparatively high costs and relative inflexibility of public flotation. The term loan was well adapted to meet this changed demand, as was the private placement of securities by issuers directly with investing institutions.[4]

Business concerns securing funds through private sales of debt securities (instead of public offerings) eliminate or reduce a number of expenses in addition to costs of registration under the Securities Act. Among the savings are underwriters' commissions (unless fees are paid third parties for bringing issuers and purchasers together), costs of advertising, costs of printing registration statements and prospectuses, outlays for engraving certificates, transfer taxes, costs of listing issues on securities exchanges, and costs of maintaining facilities for transferring securities. Greater speed in financing and more expeditious modification of loan indentures to meet changed circumstances of borrowers are additional, and im-

[3] The cost of flotation for underwritten bond issues during 1938-39 dropped consistently from 7.5 percent for issues under $1 million to 3.4 percent for issues of from $1 million to $5 million, to 2.8 percent for issues of from $5 million to $20 million, and to 2.4 percent for issues of $20 million and over. See Securities and Exchange Commission, *Cost of Flotation for Registered Securities, 1938-1939* (Washington, 1941) p. 4.

[4] Purchase of corporate securities directly from issuers without registration has been estimated to comprise 44 percent of the total dollar amount of domestic and foreign corporate issues during 1940. See House Committee on Interstate and Foreign Commerce, 77th Congress, 1st Session, *Hearings on H.R. 4344, H.R. 5065 and H.R. 5832* (Washington, 1941) Part II, p. 366. However, it is likely that term loans of substantial amount are included in the "direct purchases" upon which the percentage is based. See p. 528.

portant, advantages of private placements and term loans over public offerings of securities.[5] Finally, the issuing corporation avoids public disclosure of corporate affairs, and its directors escape potential civil liabilities under the Securities Act. It is not unlikely that these factors are even more important than the cost of public offerings of securities in explaining the growth of term lending and direct financing.

The major disadvantage of a private placement, from the point of view of an issuing concern, is lack of broad marketability. This precludes the occasional repurchase of securities at advantageous prices in the open market. However, lack of marketability is not a critical disadvantage to the institution holding a private placement. It appears that the SEC will permit a holder subsequently to dispose of such an issue without registration, providing disposition is not made to so many buyers as to constitute a public offering, and does not occur so soon after private purchase as to deprive the issue of the character of an "investment" by the reselling institution.[6] In fact, in order to provide for the contingency of resale, the formal features of marketability are generally preserved in an issue privately placed, such as provision for exchange of engraved bonds of smaller denomination for the bonds of larger denomination given at time of original purchase, and provision for registration of the issue on securities exchanges under certain conditions. A broader consideration is that the merit which public marketability has possessed, both to issuers and purchasers of corporate securities, has become steadily less through time as a result of "thinner" securities markets and the institutionalization of the investment process.

A number of other forces came into play during or after

[5] Churchill Rodgers, "Purchase by Life Insurance Companies of Securities Privately Offered," *Harvard Law Review*, Vol. LII, No. 5 (March 1939).

[6] During June 1941, Equitable Life Assurance Society of the United States purchased $35,393,000 of first mortgage 3¼ percent bonds due 1971 of the New York State Electric and Gas Corporation. Less than four months later, on September 22, 1941, Equitable sold a blook of $10,000,000 of this issue to "not more than twenty other institutional investors" through Salomon Brothers and Hutzler, as agents. See *New York Times*, September 23, 1941.

1933 that have tended to increase the demand for medium-term credit. These included the following:

1. The sharp decline in interest rates has resulted in much term borrowing from commercial banks to refund outstanding bonds or debentures sold during past years when much higher interest rates obtained. Many industrial concerns sold long-term debt securities during the 1920's to yield 5 to 8 percent per annum, and were able to pay them off with the proceeds of term loans contracted at from 2 to 4 percent per annum. The quantitative importance of this factor is indicated by the evidence that a third of the number of term loans, accounting for more than half of the amount of term credit, have been used *solely* by borrowers for repayment of debt or retirement of preferred stocks. Since the incentive for such term borrowing will partially disappear when interest rates stop falling, refunding is a less reliable basis for a continued high volume of term lending than is the acquisition by business of new fixed or working capital. But refunding consistently played a role from 1933 through 1940.

2. The growing weight of corporate taxation has reduced net income available for the internal financing of expansion and has made it increasingly difficult for borrowers to discharge outstanding debt according to original schedule. The rates of the Federal tax on corporate net income have risen substantially since 1933. Surtaxes on undistributed net incomes were effective during 1936 and 1937. Beginning in 1940, taxes were laid on "excess profits" in an effort to prevent the high level of industrial activity generated by the national defense effort from producing large business profits. The combined effect of these levies has been to cause expanding businesses to seek term loans, and to compel indebted businesses to use money procured from term borrowing to refund debts that could not be canceled through the application of retained profits. Many concerns have, therefore, not only sought term credit, but have experienced a decline in their ability to get out of debt. Business taxation is an influence

likely to condition the demand for term loans for many years to come.

3. Relatively growing labor costs have given impetus to the installation of labor-saving machinery and equipment or the reorganization of productive facilities, thus increasing the demand for funds to finance these operations. One result of the labor organization movement that developed throughout the United States with such strength after 1933 was an increase in the cost of labor relative to the costs of other productive factors.[7] In many industries, including the textile, paper, and bituminous coal industries, management has met this situation by the substitution of machinery for human labor, often offsetting higher labor costs or even reducing average unit costs of production. Term loans have been peculiarly adapted to finance the acquisition of machinery or the reorganization of facilities because it is often possible to compute the annual dollar savings accruing therefrom and to gear the amortization schedule of the loan to these savings.

Reduction in Returns Obtainable by Banks from Investment in Alternative Media

On the supply side of the business credit market, the salient question to be answered is: What factors caused business financing agencies, especially commercial banks, to be able and willing to meet the demands for term loans that expanded so rapidly after 1933? The answer is to be found, first, in the increase in funds in the hands of commercial banks and other investing institutions, not investible in alternative assets with yields as attractive as those of term loans; and second, in the actions of public financing agencies and regulatory bodies that enabled private credit-granting agencies to enter the field of term credits with more assurance.

Underlying the expansion in the supply of term credit has been the phenomenal increase since 1932 in the excess re-

[7] The increase in labor costs is, of course, measured very incompletely by the rise in wage rates. Fully as important in many instances are the costs of slow-downs or shut-downs as a result of labor disputes and the cost of managerial time devoted to problems of labor relations.

serves of commercial banks. Since 1934, excess reserves have rarely been less than $2 billion, except during 1937, and they rose to well over $6 billion during 1940. This expansion occurred despite substantial increases in legal reserve requirements. Investible funds in the hands of life insurance companies also have grown steadily in this period.

Concurrently with the immense expansion of the supply of funds available for lending by the principal private institutions participating in the term loan market, there has been a marked reduction in the rates of return that these institutions could earn by placing their funds in other media. Average yields of United States Treasury obligations and of high-grade corporate bonds have fallen precipitously since 1933. Call loans collateralized by securities have earned only 1 percent per annum for a number of years. Sharp curtailment has occurred in the demand for loans collateralized by marketable securities, resulting in part from the increased margin requirements imposed by the Federal Reserve authorities under the Banking Act of 1935. Although personal loans and consumer instalment financing have provided broadening avenues for profitable employment of bank funds, the potential magnitude of such uses has not nearly matched the amount of idle bank funds awaiting employment. All these factors have swollen the supply of funds available for term loans.

Facilitating Activities of Public Credit and Supervisory Agencies

Despite the emergence of broad demands for term loans after 1933, and a concomitant increase in the *ability* of commercial banks to meet them, it is improbable that the subsequent burst of term lending by commercial banks would have materialized had there not been inaugurated certain public institutions and changes in bank supervisory policy. These greatly increased, if they did not actually create, a *willingness* of the commercial banking system to make term loans in volume. Among them the following factors were significant:

1. Under several Acts of Congress the ability of member banks of the Federal Reserve System to obtain cash from Federal Reserve banks for items in their portfolios was greatly expanded. In consequence, banks could make loans maturing in three, five, or more years with less risk of becoming frozen. After their experiences of 1930-33, when the rush of the public to obtain cash had compelled many banks rapidly to liquidate loans and investments upon the best terms they could get, bankers were exceedingly sensitive to the need for liquidity in their loans and investments. Moved by the events of these years, Congress successively broadened the ability of banks in time of monetary stringency to rediscount or to obtain advances upon the pledge of banking assets. Without detailing these changes, it is sufficient to observe that by the end of 1933 member banks could obtain cash for any sound asset held by them.[8] There can be no doubt that this broadening of the rediscount and advance powers of the Federal Reserve banks exerted an important although unmeasurable influence upon commercial banks toward the extension of credits which, in case of a sudden rush to liquidity by the public, could be turned into cash by other means than by collection from the borrowers.

2. The inauguration in 1933 of deposit insurance by the Federal Deposit Insurance Corporation tended to produce a similar change in bankers' attitudes toward term loans but for a different reason.[9] It was believed that the existence of insurance would minimize the likelihood of widespread and sudden runs by depositors for cash. It may be that greater stability in the deposits of small banks is reflected in greater stability of their deposits in correspondent banks located in larger cities. Whether or not well founded, this belief of bankers that deposit insurance increased the stability of deposits would *per se* have increased the willingness of banks to make longer

[8] The legislation accomplishing these reforms includes the following: Act of February 27, 1932 (47 Stat. 56, ch. 58); Act of February 3, 1933 (47 Stat. 794, ch. 34); Act of March 9, 1933 (48 Stat. 1, ch. 1); Act of August 23, 1935 (49 Stat. 684, ch. 614).

[9] Act of June 16, 1933 (Banking Act of 1933) 48 Stat. 162, ch. 89.

term loans, even without the privilege of cashing them at the Federal Reserve banks in case of need.[10] As it was, deposit insurance fortified the influence of the broadened Reserve bank credit facilities.

3. The activities of the Federal Reserve banks and of the Reconstruction Finance Corporation in making term loans directly to business concerns helped set the stage for action by private financing agencies in these fields. It would be incorrect to say that the public agencies originated term lending, for there is evidence that a number of commercial banks made term loans prior to June 1934, at which time both Federal Reserve banks and the RFC were equipped with industrial loan powers.[11] But indubitably the actions of these agencies educated many commercial banks in the techniques of making term loans. They also facilitated the extension of bank term credits by offering to, and taking from, commercial banks participations in term loans, and by assuming substantial proportions of the credit risks through the taking of commitments on loans made by private agencies. The quantitative importance of the Federal Reserve banks and the RFC in the development of term lending is not adequately measured by the volume of term loans disbursed relative to those of commercial banks. Judged only by this standard, their influence has been comparatively small. Up to the end of 1940 the aggregate volume of business credit disbursed by Federal Reserve banks and the RFC was in the neighborhood of $300 million, only a small fraction of an indicated term loan volume

[10] In passing, it may be noted that the deposit insurance premium of 1/12 percent per annum of the average amount of deposits held by a bank has become a considerable item of expense, especially to the larger city banks. By preventing deposits from being costless to banks, the premium has put some pressure on bankers to translate cash into earning assets, including term loans. Although it is impossible to evaluate the influence of deposit insurance upon term lending in quantitative terms, discussion of the subject with many bank loan officers indicates that this influence has not been negligible in importance.

[11] These powers were granted by the addition of Section 13b of the Federal Reserve Act, Act of June 19, 1934 (48 Stat. 1105, ch. 653), and by the amendment of Section 5d of the Reconstruction Finance Corporation Act, Act of June 19, 1934 (48 Stat. 1108).

of commercial banks of at least $2.5 billion up to that date.[12] Yet it is highly probable that the familiarity with medium-term loans gained by commercial bankers through observation of, or participation in, term credits extended by the two public agencies was directly responsible for a very large volume of term lending on their part.

4. The inauguration of real estate mortgage insurance during 1934 by the Federal Housing Administration must also be counted as an influence that tended to expand the supply of term loan credit.[13] Only mortgage loans that conformed to the specifications of the FHA were eligible for insurance. The essential innovation wrought by FHA, in defining credits eligible for insurance, was to substitute a definite predetermined plan of amortizing a long-term loan for the former plan of making a medium-term loan without specific amortization features and with the expectation of renewal. In short, the FHA was primarily responsible for bringing about a change in the nature of real estate mortgage credit parallel in its significance to the adaptation made by commercial banks from the traditional short-term business loan to the medium-term loan. Since nearly all commercial banks acquired experience with insured FHA loans after 1934, there was undoubtedly some carry-over to the business loan market of knowledge gained in the real estate mortgage loan market. Bankers became more acutely aware of the fact that terms of loans could often be safely extended beyond traditional limits if amounts of debts were systematically reduced in accordance with the income and expenditure pattern of the borrower.[14] Term lending may be viewed as part of a basic

[12] See Table 1 and Appendix A.

[13] See National Housing Act, approved June 27, 1934. Public, No. 479, 73d Congress (48 Stat. 1246).

[14] Somewhat similar to the FHA real estate mortgage insurance program in its effect upon term lending was the provision of Federal ship mortgage insurance by the United States Maritime Commission under the Merchant Marine Act of 1936, Title XI. Briefly, this permits the Maritime Commission to insure repayment of a loan secured by a mortgage on a Federal ship which is being constructed, reconditioned or repaired with the proceeds of the loan. Terms of such insured mortgage loans may not exceed 20 years. The influence of this legislation upon private financing of ship construction and repair has been

transition now occurring in American banking, a transition whose keystone is the development of loans made on an amortization basis, with the borrower looking primarily to the income received by the debtor for repayment.

5. Revised policies and methods of bank examination have increased the supply of funds available for term loans. For some time prior to 1934 the practice was general among Federal and state supervisory authorities of classifying criticized loans in three categories: "estimated loss," "doubtful," and "slow." There is evidence that some bank examiners habitually classified loans which were not strictly of a seasonal character as "slow," regardless of their soundness and the certainty of their ultimate collection. They put pressure on banks to liquidate slow loans that were outstanding, and discouraged banks from lending to business concerns in any other way than through the traditional short-term note payable in entirety at maturity.[15] Although a recommendation was adopted at a joint bank examiners' conference in September 1934 to clarify the slow classification so as to *exclude* therefrom loans reasonably certain of payment, whatever their maturities, it was not until June 1938 that an agreement was adopted by the examining agencies to discontinue use of the slow classification altogether.[16] Commercial bankers have since scored examiners, in individual cases, for failing to adhere to the principles of the examination agreement, and for continuing to criticize capital and other long-term loans *per se*,

[15] Investigators of the Secretary of the Treasury reported this condition in the Seventh Federal Reserve District during 1934, and stated: "There appears to be sufficient evidence to indicate that the smaller banks have a considerable fear of examiners and that their lending policies are thereby directly restricted." Charles O. Hardy and Jacob Viner, *Report on the Availability of Bank Credit in the Seventh Federal Reserve District,* submitted to the Secretary of the Treasury (Washington, 1935) p. 20.

[16] See Federal Deposit Insurance Corporation, *Annual Report, 1938,* pp. 61-64.

comparatively slight up to the present time, mainly because the financing agency can obtain a contract of insurance only upon a completed ship, and until the ship is in service the only security of the bank consists of an incomplete ship plus the performance bond of the construction company. See United States Maritime Commission, *Federal Ship Mortgage Insurance under Title XI, Merchant Marine Act, 1936, As Amended,* "Rules and Regulations" (Washington, 1939).

irrespective of the certainty of their ultimate repayment.[17] Nevertheless, 1934 marked a definite pronouncement of policy, and appears also to have witnessed the beginning of a gradual change in the operating practices of bank examination, a change tending to remove a disability under which term lending had labored.

6. Changes in the public regulation of commercial bank investments have also affected the supply of term loans. The unprecedented decline in market prices of all but the highest-grade corporate bonds after 1929 led bankers to look with disfavor upon bonds and notes of mediocre quality, or upon small issues of debt securities subject to wide price variations. This operated to increase their ability to make term loans. Moreover, accepted bank examination practices in valuing marketable securities tended to increase their willingness to do so. Securities were valued at market prices for national banks up to 1936 and for all state banks up to 1938. Any deficiency in current market value below cost, at time of examination, was regarded as "estimated loss" and required to be written off. This procedure placed the capital position of a bank subject to the vagaries of changes in interest rates, speculative fervor, and other erratic influences not always related to long-term values of security holdings. Especially was this true of securities not of top quality. Consequently many bankers came to prefer to extend credit in the form of term loans, which did not carry the threat of rapid and erratic revaluation. During 1938 Federal and state supervisory authorities adopted a uniform procedure for valuing securities which mitigated, but did not entirely remove, the disability under which security purchases labored as compared with term loans. Roughly, this procedure called for the valuation of high-grade securities at cost,[18] and of lower-grade securities not in default at average market prices during the preceding eighteen months.

[17] See *The Answers of the American Bankers Association* in reply to a questionnaire of the U. S. Senate Committee on Banking and Currency (Research Council, American Bankers Association, New York, April 1941) p. 42.

[18] Less amortization of premium, if any.

The expansive effect this action normally would have had on the volume of bank purchases of corporate securities was, however, more than offset by the adoption during 1938 of another regulation regarding commercial bank investments. As applied in practice by most bank examiners, this regulation prohibited banks from purchasing corporate securities not placed in the four highest rating groups by the security rating sevices. As a result, small concerns which do not find it profitable to market securities publicly and larger enterprises whose financial circumstances do not earn acceptable ratings for their securities are precluded from obtaining bank credit through security issuance. The natural consequence was to increase the supply of term loan credit to such firms in these classes as could meet bank credit standards for loans. While essentially unmeasurable, this influence on the volume of term lending has undoubtedly been significant. In summary, the *net* effect of changes in the regulation of bank investments since 1933 has undoubtedly been to augment the supply of term loan credit.